BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)	
)	No. 82A-1801-GO
SUMITOMO BANK OF CALIFORNIA)	84A-1017
AND THE SUMITOMO BANK, LTD.)	
OF OSAKA, JAPAN)	

For Appellants: Michael H. Love
Attorney at Law

For Respondent: Elleene K. Tessier
Counsel

O P I N I O N

These appeals were originally made *pursuant* to section 25666 1/ of tie Revenue and Taxation Cade fram the action of the Franchise Tar Board on the protests of Sumitomo Bank of California and The Sumitomo Bank, Ltd. of Osaka, Japan, against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue,.

Appeals of Sumitomo Bank of California and The Sumitomo Bank, Ltd. of Osaka, Japan

	Income Years Ended	Proposed Assessments
Sumitomo Bank of California	12-31-69	$177,380.57
	12-31-70	121,745.44
	12-31-71	298,426.01
	12-31-72	168,495.51
	12-31-73	80,052.83
	12-31-74	81,055.65
The Sumitomo Bank, Ltd.	9-30-72	118.09
	9-30-73	29,722.04
	9-30-74	74,080.02

Subsequent to the filing of these appeals, appellants paid the proposed assessments in full. Accordingly, pursuant to section 26078, these appeals are treated as appeals from the denial of claims for refund.

Appeals of Sumitomo Bank of California
and The Sumitomo Bank, Ltd. of Osaka, Japan

Two primary questions are presented by these consolidated appeals: (1) whether appellants were engaged in a single unitary business during the appeal years, and (2) if so, whether respondent properly determined that appellants must file a combined report and use the standard apportionment formula to compute income derived from or attributable to California sources.

The Sumitomo Bank, Ltd. (hereinafter "SBL") was founded in Osaka, Japan, in 1895 as a private *bank* by the Sumitomo family and is one of the world's leading commercial banks. Its overseas activities are currently carried on through agencies in the United States; by branches in Europe and Asia; by Banco Sumitomo Brasileiro, Brazil, a wholly owned subsidiary of SBL; and by Sumitomo Bank of California.

Sumitomo Bank of California (hereinafter 'SBC") was organized under the laws of the State of California on November 14, 1952, and commenced business on February 2, 1953, SBC performs all of the usual functions of a domestic commercial bank. In 1972, SBC established a Nassau branch, its only branch outside California.

During 1969 through 1974, SBL owned approximately 55 percent of SBC's outstanding *shares.* SBC owned no shares of SBL. From 1969 through the latter part of 1972, SBL had no contact with California, In 1972, SBL opened a San Francisco agency in order to facilitate certain types of transactions with SBC. During the period under review, SBC had been particularly active in the field of international banking, providing services including commercial letters of credit, foreign exchange, collections, remittances, *foreign* trade financing, and acceptance financing. It had maintained, through its parent bank, a comprehensive network of correspondent relationships with commercial banks in foreign countries which provided foreign banking. facilities for its customers. In 1970, two separate International Banking Divisions - one in San Francisco and the other in Los Angeles - were established. SBC participated in loans jointly with SBL's New York and San Francisco agencies and engaged in extensive dealings with SBL, particularly in connection with import and export transactions. (Resp. Br. at 2 & 3.)

From the founding of SBC to the present, virtually all of the top echelon personnel of SBC, including

the president, executive vice president, all senior vice presidents and almost one-half of all the other vice presidents were "on loan" from SBL. (Resp. Br. at 4.) In addition, other important SBC positions were held by SBL employees. SBL's employees served in California an average of five to seven years. With respect to locally recruited SBC personnel, approximately two to four employees per year were sent to Osaka for a one month period to receive direct training from SBL. (Resp. Br. at 4.) In addition to this exchange of personnel, a majority of SBC's board of directors were either SBL employees or SBC employees 'on loan" from SBL. (Resp. Br. at 5.)

Because of the rapid expansion of SBC there was a constant need to increase capital funds. SBL continuously added capital as required for expansion or by the regulatory bodies. For example, after an October 2, 1970, state banking report cited SBC for lack of capital funds because the capital ratio had decreased to 7.1 percent, considerably below the state ratio for banks of comparable size, SBC sent a letter to the state banking authorities announcing the issuance of convertable debentures to increase capital. The direct contributions of capital during this period by SBL's purchase or debentures constituted $12 million. In addition to SBL's direct contribution, SBL also controlled the amount of debentures that was issued to the public, thus ensuring that it retained control of SBC.

In all federal and state banking reports issued during the appeal period, reference was made to SBC's concentration of credit to various Japanese headquartered firms and their American subsidiaries. The reason for this large concentration of credit within SBC appears to be that the Japanese parent companies were customers of SBL; therefore, when these Japanese companies needed financing for their American subsidiaries, they used the SBL banking system to furnish services needed in America. Together, SBC and the SBL agencies noted above offered full banking services to these customers. SBL and SBC made loans, handled import/export financing through the parent bank's comprehensive worldwide network and SBC provided local domestic services. (Resp. Br. at 6.)

All credit granted by SBC and the San Francisco agency of SBL to Japanese companies and their American

subsidiaries was approved by SBL. As such, SBL controlled the granting of credit for these companies on a worldwide basis. This relieved SBC and the San *Francisco* agency from conducting costly credit work. Federal and state banking reports cited SBC for violation of credit procedures such as lack of financial statements, guaranties over four years, and not enough signatures on borrowing resolutions. Whenever SBC *was* cited for violations by the State Banking Department or the FDIC and could not rectify the situation on its own, SBL came to its aid.

The close business relationship between SBC and SBL is also shown by the intercompany deposits. From February 3, 1959, to March 31, 1971, SBL placed a $5,000,000 deposit with SBC as a guaranty for certain loans covered under a February 1959 agreement. The *original* agreement provided for no interest, but for the appeal period, interest was charged at 7 1/2 percent. Such time deposits provided SBC with capital, while demand deposits with affiliates facilitated the worldwide business of the Sumitomo network. (Resp. Br. at 7.1

The amount of a financial institution's capital affects violations regarding loans, acceptances, and letters of credit exceeding legal limitations which are based on capital. For example, section 1310 of the Financial Code, *as* then *in* effect, stated that loans to one customer could not exceed 10 percent (unsecured) or 20 percent (secured) of capital plus surplus of a bank. To prevent being cited for this violation, SBL aided SBC by increasing capital and thereby increasing lending limits and accepting participation loans or sales of excess loans over limit. (Resp. Br. at 8.) Furthermore, a large portion of SBC loans, letters of credit, acceptances and participations was guaranteed by SBL. These guaranties were initiated because FDIC and state banking authorities, concerned about the concentration of credit with Japanese companies and their American subsidiaries, required some assurance concerning these Loans, The methods of guaranty included continuing guaranties and stand-by letters of credit. SBC also engaged in extensive selling and purchasing of loans and acceptances with its affiliates. Acceptances and letters of credit over limit were almost always sold to affiliates during most of the appeal period.

Further evidence of intercompany ties is found in the joint use of staff and facilities. There was a sharing of physical facilities by SBC and the San Francisco agency. Basically, the agency's operations were carried out by SBC's employees on SBC's equipment with the agency paying rent for the leased property. Wages were allocated by estimates of time- (Resp. Br. at 9.)

During the appeal period, SBC presented itself to the public as a member of the SBL banking network and/or the entire Sumitomo group of corporations. The most obvious presentation of affiliation is the common name of Sumitomo used by SBC. SBC also presented itself as a member of a worldwide group *in* its annual reports. SEC stated that its worldwide network could benefit customers by having facilities around the world and indicated that the name Sumitomo is known and respected worldwide and that the expertise of SBL benefits SBC. SBL also presented itself as an international bank with a worldwide network in its advertising. SBL recommended that potential customers contact the Sumitomo bank nearest them and listed the California bank. In an advertising pamphlet given to the public by SBC, SBC stated that its affiliation with SBL and the Sumitomo group gave SBC a "very real advantage in international trade." (Resp. Br. at 10.) Lastly, SBL also had a research staff that provided economic data concerning investment opportunities in different geographical areas or different types of investments. (Resp. Br. at 10.)

Throughout the appeal period, SBL and SBC filed California franchise tax returns employing separate accounting. Upon audit, respondent determined that SBC and SBL were engaged in a single unitary business and, accordingly, redetermined appellants' California source income using combined reporting procedures. Appellants protested the proposed assessments. The protests were denied and these appeals followed.

When a taxpayer derives income from sources both within and without California, its tax liability is measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with affiliated corporations, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the

affiliated corporations. (See Edison California *Stores,* Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) A unitary business exists when there is unity of ownership, unity of operation, and unity of use (Butler Bros. v. McColgan, 17 Cal.2d 664, 678 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942)) or when the operation of the business within California contributes to or is dependent upon the operation of the business outside this state (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481).

On appeal, appellants have offered no factual argument that they were not engaged in a unitary business. Accordingly, based on the record, we are compelled to conclude that, as a matter of fact, appellants were engaged in a single unitary business during the appeal years. (See, e.g., Appeal of New Home Sewing Machine Company, Cal. St. Bd. of Equal., Aug. 17, 1982.) Therefore, for the years on appeal, appellants' income derived from or attributable to California sources must be determined in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120 through 25139. (Rev. & Tax. Code, § 25101.) UDITPA requires that the business income of a unitary business be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus *the* payroll factor plus the sales factor and the denominator of which is three, (Rev. & Tax. Cade, § 25128.) The numerators of the respective factors are composed of the taxpayer's proptrty, payroll, and sales in California and the denominators consist of the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, a 25134.) Methods other than the standard three-factor formula may be used only in exceptional circumstances where UDITPA's provisions do not fairly represent the extent of the taxpayer's business activity in this state. (Rev. & Tax, Code, § 25137.) *The party seeking* to deviate from the standard formula bears the burden of proving that such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

To this end, appellants argue that respondent should permit separate accounting in this situation since appellants are highly regulated, regularly audited, financial institutions which cannot manipulate income. Moreover, appellants contend that in an international setting, combined reporting unfairly distorts each

appellant's income and imposes significant reporting requirements that are unfairly and unnecessarily burdensome to appellants. Appellants also contend that separate accounting should be required because combined reporting does not fairly represent the extent of each appellant's business in California. (App. Br. at 5.) Additionally, appellants maintain that to calculate their tax liability on a combined basis violates the Commerce, Due Process and Equal Protection Clauses of the United States and California Constitutions. (App. Ltr. received March 11, 1983.) Finally, appellants argue that respondent's action violates section 1753 of the California Financial Code, which requires a foreign bank doing business in California to use separate accounting methods. (App. Br. at 7.)

Appellants argue that we have adopted their view concerning the use of separate accounting for financial institutions in Appeal of Western Loan and Building Company, decided on June 18, 1943. The direct answer to that allegation is that the facts in Western Loan are distinguishable from the facts in the appeals now before us. In Western Loan, we stated that "[i]n this case it is possible to determine the gross income from investments, activities and sales of property in each state." We added there that transactions in other states did not affect transactions which occurred in California and that income realized from California transactions could be localized. However, as outlined above, the facts in these appeals permit no such localization. Unlike the taxpayers in Western Loan, appellants here systematically participated in loans jointly. During the period at issue, SBC concentrated in granting credit to various Japanese-headquartered firms and their American subsidiaries. Japanese customers of SBL used SBC to finance their American subsidiaries and SBL controlled the granting of credit to such companies by SBC, thereby relieving SBC of the burden and cost of credit background work. The symbiotic relationship between SBL and SBC is further highlighted by the intercompany deposits noted above. No such pattern of intercompany loans and deposits was noted in Western Loan. Moreover, SBL aided SBC by increasing SBC capital and lending limits as needed, accepting participation loans, issuing guaranties of sac transactions and fostering joint use of staff and facilities. Again, no such pattern of joint action is evident in Western Loan. Also, unlike the taxpayer in Western Loan, SBC presents itself as a member of a worldwide group which further

obscures the source of any income. Accordingly, unlike Western Loan, no localization of income realized in California is possible in the instant situation. Thus, on its facts, Western Loan is distinguishable from the instant appeals.

In this same vein, appellant argues that California Financial Cade section 1753, as in effect during the years at issue, mandates the use of separate accounting in these appeals, Briefly, this section required that a foreign banking corporation doing business in California "keep the assets of its California business entirely separate and apart from the assets of its business outside California . . . . Appellants conclude that this section and the extensive financial review required by banking authorities mandates that they use separate accounting for tax purposes during the years at issue. (App. Br. at 8.) Respondent answers that Financial Code section 1753 served "an entirely different purpose than those provisions requiring that a unitary business determine its income using the formulary method," (Resp. Br. at 32.) Indeed, we have uncovered no authority which would suggest that the Financial Code has any application to state taxation. Moreover, we have previously held that the usual methods and formulas are appropriate for determining a domestic bank's and foreign bank's measure of tax when such banks arc engaged in a unitary business. (Appeal of California First Bank, Cal. St. Rd. of Equal., June 25, 1985; Appeal of The Bank of Tokyo, Ltd., Cal. St. Bd. of Equal,, June 25, 1985.) Accordingly, we must hold that appellants' argument with respect to Financial Code section 1753 is withaut merit,

Appellants next argue that combined reporting does not result in a fair representation of the extent of their business in this state because of alleged distortions from imprecise "conversion methods," disparity between California and Japan with respect to costs and wages, and alleged distortion caused by currency fluctuations. (App. Reply Br. at 3.) Accordingly, appellants contend that the standard three-factor formula does not fairly represent the extent of their business in California. As indicated above, the party seeking to deviate from the standard formula bears the burden of proving such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., supra.)

We have previously considered and rejected arguments concerning currency fluctuations in the Appeal

of Mew Home Sewing Machine Company, supra. For the reasons stated in that opinion, we must reject appellants' arguments with respect to currency fluctuation as unconvincing here. Moreover, with respect to appellants' other arguments, no showing has been made indicating that any variations which might occur prevent the standard apportionment formula from fairly representing the extent of the taxpayers' business activity in this state. Again, based upon the record presented, we must also reject these arguments as unconvincing. Accordingly, we must conclude that appellants have not met their burden of proving that such exceptional circumstances exist to allow deviation from the standard formula.

Appellants also contend that California's statutory scheme of taxiny unitary businesses is unconstitutional. However, article III, section 3.5, of the California Constitution precludes this board *from* determining that the statutes involved are unconstitutional or unenforceable.

In summary, we find that appellants have failed to show-any error in respondent's determination of unity or that the ordinary allocation and apportionment provisions of UDITPA do not fairly reflect the extent of their business activity in California. Respondent's action, therefore, must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Sumitomo Bank of California and The Sumitomo Bank, Ltd. of Osaka, Japan, for refund of franchise tax in the amounts of and for the income years, as follows:

	Income Years Ended	Claims for Refund
Sumitomo Bank of California	12-31-69	$177,380.57
	12-31-70	121,745.44
	12-31-71	298,426.01
	12-31-72	168,495.51
	12-31-73	80,052.83
	12-31-74	81,055.65
The Sumitomo Bank, Ltd.	g-30-72	118.09
	g-30-73	29,722.04
	g-30-74	74,080.02

be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of May, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9